

Internal Revenue Service  
**memorandum**

CC:TL-N-1480-88

Brl:JCalbro

date: **JAN 22 1988**

to: District Counsel, Manhattan      CC:NA  
Attn: Robert Sadowski

from: Acting Director, Tax Litigation Division CC:TL

subject: [REDACTED]

This is in response to your request for technical advice dated November 17, 1987 concerning the above-mentioned case.

ISSUE

Must an accrual basis taxpayer recognize income from refunds of state and local franchise taxes, which are attributable to net operating loss carrybacks, in the taxable year of the loss giving rise to the claim or in the year the right to refunds is ultimately determined? RIRA No. 0451.04-00.

CONCLUSION

A taxpayer must include in income the appropriate portion of a state tax refund that is attributable to a net operating loss (NOL) in the year the taxpayer sustained the loss.

FACTS

Petitioner, an accrual basis taxpayer, for its fiscal year ending [REDACTED] filed claims with the appropriate authorities for (1) a refund of New York State franchise taxes in the amount of \$ [REDACTED], and (2) a refund of New York City corporate income taxes in the amount of \$ [REDACTED]. These claims for refund were based upon losses incurred by the petitioner on its domestic operations. The petitioner's claims for refund were under audit as of [REDACTED]. The claim for refund from New York State was determined in the fiscal year ending [REDACTED], resulting in a refund of approximately \$ [REDACTED]. The claim for refund from New York City has not as yet been determined.

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The Service, relying on Rev. Rul. 65-190, 1965-2 C.B. 150 determined that the refunds should be included in income in the taxable year ending [REDACTED], in the amount of \$ [REDACTED], such sum representing claims for refunds of New York State franchise taxes and New York City corporate income taxes. In accordance with the all events test, the rationale of Rev. Rul. 65-190 is that, since the amount of the loss can be calculated with reasonable accuracy the refund should be included in gross income at the time the loss giving rise to the refund occurs. The fact that the refund was subject to approval by the appropriate third party should not prevent accrual of the income since, it is reasonable to expect the taxing authorities to approve a valid, accurate and properly submitted claim. Contrary to Rev. Rul. 65-190, the Tax Court held that, a refund of New York State franchise taxes and New York City corporate income taxes does not accrue until the year in which the right to the refund is ultimately determined by the State. Doyle, Dane, Bernbach, Inc., v. Commissioner, 79 T.C. 101 (1982). In Doyle, the Tax Court mentioned Rev. Rul. 65-190 and rejected it as based "on a foundation which is shaky at best." Id. at 106.

#### DISCUSSION

Treas. Reg. § 1.451-1(a) provides that an accrual method taxpayer must accrue income when all events fixing the right to such income have occurred and the amount can be determined with reasonable accuracy. Rev. Rul. 65-190, 1965-2 C.B. 150 provides that for Federal income tax purposes, an accrual method taxpayer must include in income a refund of New York State corporation franchise taxes, resulting from a NOL carryback, in the taxable year of the loss effecting such a refund. The ruling thus requires inclusion in income in that year even though third persons may need to perform additional acts as long as it is reasonable to expect that the acts will be performed. Yet, Rev. Rul. 62-160, 1962-2 C.B. 139, holds that interest on a refund of Federal tax accrues when a taxpayer's right to receipt of the refund is determined; that is, in the year that an authorized representative of the Internal Revenue Service certifies the allowance of an overassessment.

Noting the inconsistency between the two rulings, the Tax Court held in Doyle, Dane, Bernbach, Inc. v. Commissioner, 79 T.C. 101 (1982) that petitioner need not include in income refunds of New York State and City franchise taxes until the year the right to those refunds is ultimately determined.

Subsequent to the Doyle decision, at the request of the Tax Litigation Division, the Interpretative Division considered the two rulings and determined that they were unreconcilable.

Interpretative Division stated that under accrual accounting principles the refunds should be included in income in the year the loss is incurred. Rev. Rul. 65-190. They disagreed with the holding in Doyle and stated that Rev. Rul. 62-160 was incorrect. Accordingly, they recommended to the Corporation Tax Division that Rev. Rul. 62-160 be reconsidered.

Tax Litigation Division's recommended Action on Decision of nonacquiescence in Doyle was not published pending completion of a proposed revenue ruling modifying Rev. Rul. 62-160. The revenue ruling project reconsidering Rev. Rul. 65-190 and Rev. Rul. 62-160 has been open for some time. We have determined that the project was subsequently expanded to include a reconsideration of several other rulings. The project, TR-33-30352-86, Accrual of Federal and State Taxes, is in the final review stages prior to publication.

The proposed ruling will formally announce the Service's decision not to follow the Tax Court's decision in Doyle and will eliminate the inconsistency between Rev. Rul. 62-160 and Rev. Rul. 65-190. The ruling states that an accrual basis taxpayer must include in income state and local tax refunds resulting from a NOL carryback in the year in which the tax loss occurred. The review of the refund claims by the various governmental authorities is a ministerial procedure that does not defer the accrual of the refunds. See Rev. Rul. 69-372, 1969-2 C.B. 104 and Rev. Rul. 65-190.

In addition, the proposed ruling states that the existence of a contest and the resolution of that contest determine when tax deficiencies and tax refunds, and the interest thereon, is includible in income or deductible under the accrual method of accounting. When a taxpayer files an income tax return, it includes facts and transactions that justify its claimed tax liability or overpayment of tax. The Service accepts the validity of these facts and transactions and the conclusions based on them unless upon audit it finds reason not to accept the return as filed. Therefore, when a taxpayer claims a refund of federal income taxes, the taxpayer must justify its claim. Justification is usually based upon an assertion of facts or transactions that were reported in the taxpayer's relevant income tax return. Inherent in the modification or amplification of facts or transactions is a contest because the Service has already accepted the initial tax return as valid. Therefore, an implied or constructive contest exists until either the Service agrees that the taxpayer is entitled to a refund or the issue is resolved by litigation. In the tax year that the contest is settled, the taxpayer must include in income all the interest that has accrued with respect to the refund in the year of settlement and in previous years. The same analysis applies to state refunds subject to section 111 of the Code (the tax benefit rule) and the interest on state refunds.

Where a deficiency is assessed against a taxpayer, a similar analysis applies. In assessing a deficiency, the Service is

inherently challenging facts or transactions that were reported by the taxpayer and asserting facts or transactions that would modify or amplify those reported facts and transactions. This also results in an implied or constructive contest. This contest is resolved by either the taxpayer accepting the deficiency or having the issue resolved by litigation. The taxpayer is entitled to deduct in the tax year the contest is resolved all the interest that has accrued with respect to the deficiency in that year and in previous years. A similar analysis applies to deficiencies asserted by state taxing authorities and the interest thereon.

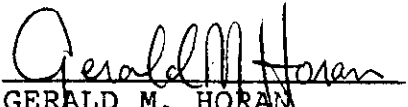
This approach of analyzing the situations in which claims for refunds and deficiency assessments arise as contests resolves the concerns of Examination because the tax consequences of the refunds and deficiencies are not recognized by a taxpayer that uses the accrual method of accounting until the tax year in which the contest is resolved. Therefore, there is no need to recalculate a taxpayer's tax liability for prior years or for taxpayers to contest tax deficiencies to preserve their deductions for state taxes and interest on state and federal taxes. See Dixie Pine Products Co. v. Commissioner, 320 U.S. 516 (1944).

In contrast with a NOL, the loss is the event which fixes the taxpayer's claim for a refund, and government processing of the claim is ministerial. See Continental Tie and Lumber Co. v. United States, 286 U.S. 290 (1932).

If you have any further questions, please contact Joyce C. Albro at 566-3521.

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